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STATE DEPARTMENT FOR EEB/IFD/OMA, EEB/EPPD.

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TAGS: ECON EFIN PO
SUBJECT: PORTUGAL: FINANCIAL SECTOR MORE STABLE

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Classified By: Gary B. Applegarth, Pol-Econ Officer, Reasons 1.4 (b) an
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SUMMARY

¶1. (C) The Portuguese financial market is more stable than it was in October and November of 2008 but the economy is still threatened by a negative trade balance, tight liquidity and rising unemployment. Pedro Penalva of AIG Europe and Paulo Gray Pereira of Citibank International told us this week several successful bond offerings by Portuguese banks totaling 4.25 billion euros demonstrate market confidence in the Portuguese financial sector, but resources are still stretched and higher capitalization requirements imposed by the GOP could trigger additional bank consolidation. Both financiers support GOP infrastructure investments to stimulate the economy provided they produce real economic benefit, and Gray said the GOP should streamline its operations and improve efficiency. End summary.

FINANCIAL SECTOR CALM BUT MORE BANK CONSOLIDATION POSSIBLE
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¶2. (C) PolEconoff met separately with Pedro Penalva of AIG Europe and Paulo Gray Pereira of Citibank International on January 12 and 13 to discuss the health of the Portuguese financial sector, updating impressions provided by the financiers several months ago (ref A). Both financiers say the situation has stabilized significantly since October
¶2008. Penalva said AIG was experiencing modest growth so far in the first quarter of 2009, a period AIG viewed as critical because of the large number of annual insurance contract renewals during that time. Gray stressed that Citi Portugal was continuing to operate conservatively, discontinuing aggressive growth programs, targeting new credit cards only to customers with higher credit ratings and focusing on collections. Citi has also reduced its workforce modestly.

¶3. (C) Penalva and Gray both cited recent successful bond offerings by Banco Comercial Portugues (BCP) for 1.5 billion euros, Caixa Geral de Depositos (CGD) for 1.25 billion euros, and Banco Espirito Santo (BES) for 1.5 billion euros as evidence of investor confidence in the Portuguese financial sector. All three offerings benefited from the 20 billion euro bank guarantee program announced by Finance Minister Teixeira dos Santos in October 2008.

¶4. (C/NF) Gray said the October 2008 GOP increase of the minimum Tier 1 capitalization requirement to 8 percent could result in additional bank consolidation and claimed BCP is the most vulnerable bank. Gray said BCP, CGD, and BES all need additional capital to reach the 8 percent level, but opined that government-operated CGD could "get a check from the government" to make-up the difference and the strong shareholders of BES would support their capitalization needs. Despite BCP's recent bond issue, Gray said BCP lacks the required capitalization and may have difficulties obtaining

additional funding, leaving the bank vulnerable to acquisition by another Portuguese bank or, more likely, by a foreign bank. Gray said consolidations were possible among smaller banks as well, but he did not identify any particular targets.

NEGATIVE TRADE BALANCE AND UNEMPLOYMENT ARE MAJOR CONCERNS

¶5. (C) Despite the improved market environment both financiers cautioned that problems remain. Penalva and Gray both expressed discomfort with Portugal's negative balance of trade, since the country's largest trading partners, Spain and Germany, were much more exposed to overvalued assets than Portugal, and both have taken heavy losses which could reduce exports to those markets. Any worsening in the balance of trade will exacerbate Portugal's need for foreign capital and further stretch available liquidity.

¶6. (C) Penalva and Gray also cited rising unemployment as an ongoing threat to the Portuguese economy. Penalva worried about the possibility of student unrest over the lack of employment opportunities in Portugal. Gray's analysis of the danger from growing unemployment was less dire but he highlighted the need for improved professional and financial education to improve the quality of Portuguese workers.

SENSIBLE INFRASTRUCTURE INVESTMENT, EFFICIENT GOVERNMENT

¶7. (C) Both financiers support GOP plans for additional infrastructure spending to stimulate the economy as long as the programs make sense. Penalva cited plans to install fiber-optic internet infrastructure as forward thinking and

necessary for future growth and competitiveness, but expressed concern that some programs, such as improved high-speed rail links within the country, benefit special business interests and will produce minimal return to the overall economy. Gray expressed similar skepticism about proposed highway projects, saying Portuguese roadways are in much better shape than the cities they connect. Penalva and Gray both also suggested the country's education system desperately needs to be overhauled, as the current system is terribly expensive and produces poor results.

¶8. (C/NF) Gray said the government should streamline operations just as the private sector has been doing. He gave the example of the "competing oversight" of financial markets by the Central Bank of Portugal (Banco de Portugal) and the Portuguese Securities Market Commission (CMVM - Commissao do Mercado de Valores Mobiliarios), claiming rationalization of their responsibilities could yield significant public savings while still providing for effective oversight. Gray said there were other examples of overlap and waste in the "bloated" government structure that should be addressed, and that this financial crisis was an opportunity the government should not miss to take bold steps that might not otherwise be politically palatable.

COMMENT

¶9. (C) The Portuguese financial market continues to weather the global financial crisis fairly well, and our financial contacts suggest the long, slow recovery has begun. While we see little chance for the youth unrest suggested by Penalva, capital scarcity and increasing unemployment certainly present daunting challenges requiring skillful economic leadership. We hope the GOP's competent deficit reduction foreshadows good future decision making, but the number of pork barrel projects in the infrastructure stimulus package tempers our expectations, and we fear more pork is on the way as domestic politics begins to overshadow structural problems in the Portuguese economy. End comment.
STEPHENSON